Feature

KEY POINTS
- Lacunae and contradictions remain in the drafting of the relevant regulations, problems exacerbated by the UK's implementation and case law.
- The use of remaining maturity as the basis for scoping bail-in raises a number of technical points pertaining to whether certain derivatives liabilities are excluded from bail-in.
- On balance it seems that porting will not constitute a Credit Event.

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'Tis said they ate each other? The interaction between OTC clearing requirements and the BRRD

This article proposes that the current FSB consultation on continuity of market infrastructures for firms in resolution needs to consider how known difficulties with the Bank Recovery and Resolution Directive (BRRD) interact with cleared OTC derivatives.

INTRODUCTION

As has previously been highlighted in this journal by the authors and others there remain several question marks about the precise operation of the Bank Recovery and Resolution Directive (BRRD) with respect to derivatives and their netting. The FSB's recent consultation on its 'Guidance on Continuity of Access to Financial Market Infrastructures for a Firm in Resolution' (December 2016) presents an opportunity to consider these problems in the context of Central Counterparties (CCPs) faced with the insolvency of a Clearing Member (CM) that is subject to resolution under the BRRD.

CCPs: OBLIGATIONS OF PAYMENT

The traditional swap relationship is bilateral between the parties economically invested in the swap. As swaps developed as a mainstay of financial practice swap brokers played a role in matching parties, but in many cases brokers only matched and did not enter into proprietary trades. Since the global financial crisis revealed significant stresses, particularly in relation to Credit Default Swaps, there were calls for reform and the innovation of CCPs was introduced as a G-20 commitment.[1] Now, with the European Markets Infrastructure Regulation (EMIR),[2] derivatives pertaining to several asset classes are required to be transacted through a CCP, the principal aim being to ensure a smooth continuation of market functioning in case of counterparty default.

CCPs apply certain risk management methods to mitigate the fallout from default including the margining system, a recovery plan and default management processes. Moreover, CCPs will only allow institutions meeting strict entrance conditions to become clearing members.

Let us consider the following example of how European-style OTC derivative clearing operates. For the sake of argument let us consider a fixed/floating interest rate swap, governed by the 2002 ISDA Master Agreement. Client wishes to fix an underlying interest rate payment obligation and so contacts Exchange Broker (EB), who also happens to be a Clearing Member of a CCP. EB locates a willing "counterparty" and affirms the trade "dropping it in" to the CCP. This is achieved by a largely automatic process: EB enters into a trade with the CCP which is back-to-back (b2b) with its own obligations to Client. The affirmation platform sends notices to another Clearing Member (CM_1) and to the CCP seeking confirmation to set up b2b trades as follows:

- a trade between Client and CM_1 on the terms of the interest rate swap (ISDA/FIA form); and
- a trade between CM_1 and CCP which is b2b the Client-CM_1 trade subject to certain additional requirements the CCP may impose on the CM_1.

On acceptance the EB trades are cancelled and EB drops out of the picture, as its role was only introductory.

As a condition of acceptance CM_1 is required to post initial margin (IM, being cash or qualifying securities) as collateral for this new risk. Through the term of the swap the CCP may seek variation margin (VM) as the mark-to-market value of the swap indicates greater risk, the VM being reduced in the converse case. With respect to both IM and VM the CM_1 seeks matched collateralisation from Client.

The Client-side establishment of these trades is matched on the Counterparty side, with a Counterparty CM_2 entering into b2b agreements with CCP. The net result should be that only Client and Counterparty should suffer contracted-for loss under the swap, with the intermediaries in the chain having zero economic exposure. It should be appreciated that the limited number of CMs means that CMs will have multiple exposures to CCPs, some of which could be Client-segregated, but which could be netted with swaps of similar types from multiple clients.

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EMIR-BRRD INTERACTION

The above clearing structure begs stress-testing and we focus on one specific issue: the entry of CM_1 into resolution under the BRRD. We assume for argument that CM_1 is subject to the UK's implementation of the BRRD under various amendments to the Banking Act 2009, although the issues inhere in the BRRD itself.

In our scenario CM_1's default is likely presaged by ratings downgrades which cause CCP to seek additional VM from CM_1 and which CM_1 may seek to pass on to Client depending on the terms of its relationship. We thus already have pre-default losses being passed to Client.

On default the European CCP regime does heed the established FSB guidance that:

> "the entry into resolution of a [CM] or use of any resolution tool should not lead to an automatic termination of its participation in the [CCP]".

This is principally achieved by:

- A post default waterfall[3] which taps *inter alia*:
  - IM;
  - CCP own-capital;
  - The default fund set up for this event, and which can be replenished.
- Porting.[4]

Porting means that our CM_1-Client trade will be novated to a non-defaulting back-up CM_3, this trade backed by a new CM_3-CCP trade on corresponding terms. In this way CM_1 is cut out of the structure and the contagion risk that could issue from the bail-in of its obligations to both CCP and Client. The risk with porting is macro-supervisory. It assumes that CM_3 exists and is capable of accepting a port, an assumption that is questionable in cases of financial system failure in which all CMs are refusing to take on new risk. This links back to the question of the macro-supervisory mechanisms for containing the default of CM_1 so that it does not spread contagion. We thus need to consider the effects of CM_1's resolution and specifically bail-in.

BAIL-IN RISKS

EMIR and BRRD are designed to work together through the latter's respect for EMIR's twin approaches of appropriate loss-absorbency (IM, VM, Default Fund) and porting. Margin-backed liabilities of CM_1 in particular should not be bailed-in. But what of CM_1's liabilities that it still owes to CCP whose value exceeds posted margin? It is difficult to assess how real the risk of under-collateralisation is. When Lehman Bros. collapsed into insolvency, John McCormack, formally of CCP LCH (and now of Nomura), reports that only a third of Lehman's margin was required to meet losses. Nevertheless the legal issue of whether the excess of liabilities may be bailed-in remains and it is not inconceivable that in an asset price spiral, the non-cash collateral in question may have been significantly written down. In such a scenario we could find that the resolution authority of CM_1 is presented with the potential option of bailing in CM_1's net liabilities to CCP.[5]

Whether this option is exercisable depends on whether the liabilities are nevertheless excluded from bail-in. The principal grounds for exclusion are:

- the maturity of the derivatives;[6]
- whether netting is to be respected;[7] and
- whether the liabilities are secured.[8]

Liabilities with a remaining maturity of less than seven days are out of scope of bail-in. It is worth noting that the clearing obligation extends to three day forwards and so it is evidently envisaged that a CM will have significant liabilities to CCP that cannot be bailed in. However, the carve-out does not turn on swap term but on remaining maturity. Thus a 50 year fixed-to-float, with six days left to run should be exempted from bail-in; not a small matter if it is designed to be physically settled at term. Advisers should take care to ensure they apply this remaining maturity test and not confuse it with other aspects of EU derivatives regulation (and its UK counterpart) which turn on the seven day term distinction (see eg Annex 1 of MiFID,[9] on which EMIR relies for its definition of "derivative").

The use of remaining maturity as the basis for scoping bail-in raises a number of technical points pertaining to the liabilities in question. If CM_1 is in default and close-out netting occurs then the net liability is:

- (arguably) immediately created; and
- immediately due and payable.

The maturity is instantaneous; the debt is owing, payable and a claim may be brought. Should such a liability not then fall within the protection for liabilities of less than seven days? This is surely not the intent of the exclusion for exclusion of closed-out liabilities renders it obsolete, but the drafting is unhelpful.

Turning to netting itself, the BRRD expressly provides that netting should be respected but it is well-known that the implementation of this requirement into UK law has been unsatisfactory and in need of remedy. In brief, the definition of "netting arrangements" which are to be protected is unusual and can be read as covering netting clauses that net existing liabilities, leaving any remaining liability owing. The ISDA and IFEMA methods of netting (correctly in our view) value outstanding trades, determine a net amount and then create a new debt in an amount equivalent to the net amount so determined. A fine point, but the English court's troubled history in interpreting close-out netting would suggest that one cannot be altogether confident that common sense will prevail should the issue of whether CM-CCP netting arrangements are protected from UK bail-in be litigated.

Now, assuming the netting is protected, we come to the issue of security. Whether these liabilities be secured is, as we have argued elsewhere, not a straightforward question. Precisely because bail-in ought only to be considered where CM_1's collateral has failed to cover its net positions we must consider whether the liabilities eligible for bail-in are not secured. This could either be because:

(i) the proprietary right to execute against the security has been exercised and there is no longer any security of which to speak, or (and the alternatives are not exclusive);

(ii) "secured liabilities" means only liabilities to the extent they are secured, eg if 100 is owing and the security realises 90 then the remaining 10 is not a "secured liability".

In the UK it is arguable that option (ii) is applicable, for the relevant statutory provision expressly speaks of liabilities "so far as secured".[10] Thus the FSB should ensure that guidance to CCPs includes a recommendation to consider contractually agreed processes that protect against the limitations of the UK "secured liabilities" carve-out. Given that clearing houses reassess VM on a daily basis[11] the probability of significant mismatch of collateral value and liabilities seems small, but in the case of non-cash-collateral in particular, a fall in the value of the securities offered leading to an intraday mismatch cannot be ruled out.

As discussed above, CM_1's provision of margin to CCP will have been undertaken on the basis that b2b margin was sought from Client. An interesting issue is what happens to the Client collateral on porting. The answer depends on whether CM_1 and Client agreed that:

- CM_1 could, as agent, charge Client's margin to CCP, such that Client is principal in respect of the margin; or
- CM would take security from Client and then re-grant security over the margin to CCP.

In the former case one would expect that on porting the margin would simply follow the Client to CM_3, and indeed LCH's Default Rules appear to envisage precisely this. Rule 8.3 provides that on porting the collateral related to the relevant contracts to be ported will be identified, the collateral balance of CM_1 will be reduced accordingly, and the collateral balance of CM_3 will be increased in an equivalent amount.[12]

As to the latter case (CM_1 re-grants collateral), CCP's security interest is required to rank prior to that of CM_1. Thus in the second case it is possible that CCP could enforce against the margin granted by Client to CM1, and indeed LCH's Procedures (not the Default Rules) envisage this:

> "The Clearing House gives no undertaking that, on the default of a Clearing Member, it will not utilize Clearing Clients' Collateral which has been transferred to it by a Clearing Member, before utilising any other form of Collateral the Clearing House may hold."[13]

This suggests a possible conflict between the porting provisions of the Default Rules and the collateral Procedures. One would expect however that the specific rules of porting would override the general principle that CCP can realize the re-granted client margin. In such case CCP would enforce its security against CM_1 purely for the purpose of enabling a transfer of the collateral balance to CM_3.

PORTING AND CREDIT EVENTS

As mentioned above, on CM_1's default, and certainly by resolution, we should expect that Client's swaps will be ported to a CM_3. This is certainly the expectation of EMIR, but what if the swap terminates on porting? More particularly, would the porting of CM_1's rights (ie assets) to another entity constitute a Credit Event Upon Merger under cl 5(b)(v)(1) ISDA 2002 Master Agreement? The relevant subclause defines such an event *inter alia* as:

> "X consolidates or amalgamates with, or merges with or into, or transfers all or substantially all of its assets (or any substantial part of the assets comprising the business conducted by X as of the date of this MA) to, or reorganises, reincorporates or reconstitutes into or as, another entity."

Given the way that Client's swap has been "dropped-in" to the CM-CCP structure it would not be unlikely that the swap relationship through CM_1 could constitute a significant part of Client's business with CM_1. Now it seems that in the case of porting only the "transfer" of relevant assets could be considered relevant. Given that porting may be effected either by novation or legal assignment it is difficult to see how porting would not constitute "transfer". It seems then that we must look to the context of this subclause to help us read it appropriately. First, one could argue that in the case of porting it is not CM_1 that is transferring anything – this is entirely an act of the CCP.[14] On a literal reading of the text then, porting is not a Credit Event Upon Merger. Additionally one could argue that the subclause envisages something far more significant – a scheme of arrangement or other restructuring other than mere porting. On balance then it would seem that porting will not constitute a Credit Event at all and so the swap would not be capable of termination on this ground.

One subtle point arises with respect to the infamous cl 2(a)(iii) ISDA Master and the English courts' interpretation thereof. If an Event of Default has occurred and is continuing, then the innocent party need not make payment on a given payment date. Consider this scenario: a payment date (the PD) occurs but CM_1 is in default; Client elects not to make payment. Client's swap is ported on PD+1 to CM_3. Is Client then obliged to make the missing payment to CM_3. Following *Lomas v JFB Firth Rixson*,[15] it would seem not, or at least, not yet.

The Court of Appeal has held that there exists a difference between a payment obligation and a debt obligation. Where cl 2(a)(iii) is engaged the payment obligation on PD may lapse, but the underlying debt to the counterparty subsists and can become due at a later time. This leaves several questions in the case of porting, designed as it is to continue, not close-out, the swap:

- When does Client's subsisting debt obligation become due?
- If CM_1 has failed to make its corresponding payments on PD, that payment obligation has not fallen away but is "live". Has CM_3 taken up this obligation on porting?
- Consequently, must CM_3 pay the gross amounts (ie without netting Client's withheld payment) to Client?

Feature

Biog box

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From CM_3's perspective, leaving the problematic payments of PD with CM_1 in resolution would be desirable, but this somewhat defeats the market continuity object of porting. A layer of complexity is added when you consider that the ultimate counterparty for Client (CM_2) is two steps away from the port. CM_2 has not defaulted and so will want to ensure that Client does not withhold payment insofar as payment should eventually reach CM_2. What then if CM_3 receives the port and:

(i) (by acquiescence) accepts Client's cl 2(a)(iii) non-payment; and/or

(ii) refuses to take-on the defaulting CM_1's payment obligation?

Do CM_3 and CCP owe some duty to CM_2 to port in a way that best preserves the expected economic outcome? Given the sums involved one would expect the point to be litigated.

Turning to other possibly relevant Credit Events, it should be noted that the Governmental Intervention Credit Event is unlikely to be applicable here. There relevant events concern the Reference Entity of a Credit Default Swap and unless a certain degree of convolution has occurred, we do not expect CM_1 to also be the Reference Entity of such a swap.

CONCLUSION

In broad terms the development of mandatory CCP clearing in the EU provides a clear response to the FSB's Guidance – many of the FSB's concerns about ensuring continuity for clients and quarantines for CMs under resolution are met by the CCP-CM structure itself (eg margin, porting). Lacunae and contradictions remain in the drafting of the relevant regulations, problems exacerbated by the UK's implementation and case law. One of the reasons for concentration of financial risk in the CCP-CM structure however is also to concentrate legal risk and to ensure that debates on matters such as netting and secured liabilities carve-outs are undertaken close to key infrastructure nodes and do not become grounds for judicial review for a multitude of small financial institutions. Further clarification and amendment would nevertheless be prudent, lest the various pressures that have caused such inconsistences as remain cause these regulations, like Duncan's horses, to turn and eat each other. ■

1 G-20 Declaration, Pittsburgh Summit, September 2009 .<http://www.fsb.org/wp-content/uploads/g20_leaders_declaration_pittsburgh_2009.pdf> accessed 23 February 2017.

2 Regulation (EU) 648/2012 of 4 July 2012 on OTC derivatives, central counterparties and trade repositories [2012] L 201/1.

3 EMIR Arts 41, 42, 45.

4 EMIR Art 39.

5 Directive 2014/59/EU of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms [2014] L 173/190 (BRRD Art 49(2)).

6 BRRD Art 44(f).

7 BRRD Art 49(3).

8 BRRD Art 44(b).

9 Directive No 2004/39/EC of 21 April 2004 on markets in financial instruments [2004] L 145/1.

10 Banking Act 2009 s 48B(8)(d).

11 See eg LCH's Rulebook Art 4.2.0.1.

12 There is potential for a reduction to be applied – see Default Rules r 4.1.

13 LCH Clearnet Ltd Procedures, s 4, para 1.2.3.

14 for example see LCH Clearnet's CDS Clearing Rulebook Art 4.3.2.3.

15 [2012] EWCA Civ 419.

Further Reading:

- All the king's men: the defences of a CCP following a clearing member's insolvency [2015] 5 JIBFL 277.
- "Caulking the ship": weather proofing the legal framework for clearing services [2017] 1 JIBFL 8.
- LexisNexis Financial Services blog: EMIR: One Minute Guide.